over the next five years. These savings include funds that would have been used to modify these aircraft. Although the bomber force would be somewhat smaller than its current size for a few years, numbers would rise somewhat above current levels as the ATB is deployed. Retiring these B-52G aircraft early would also reduce demand for tankers for aerial refueling, thus easing the shortfall for that aircraft.

There would be another advantage as well. The SALT II treaty limits to 1,320 the numbers of multiple warhead missiles and bombers carrying air-launched cruise missiles (ALCMs); a further sublimit constrains the number of multiple warhead missiles to 1,200. If other forces are introduced as planned, having more than 120 bombers carrying ALCMs would require compensatory reductions in multiple warhead missiles. Although the Administration is no longer adhering to the unratified SALT II treaty, the Congress formally expressed its sense that the United States should continue to adhere to the numerical sublimits so long as the Soviet Union continued to do so. If older B-52Gs were retired early, all B-52Hs and some B-1Bs could be modified to carry cruise missiles without exceeding these limits. Modernization would not cause the United States to bump up against the SALT limits again until September 1988, when the ninth Trident submarine is scheduled to begin sea trials.

DEF-17 ALTER OPERATION AND MAINTENANCE FUNDING

	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1988	1989	1990	1991	1992	
Savings from Administration's Request						
Budget Authority	2,430	2,540	2,720	2,870	3,010	13,570
Outlays	1,840	2,430	2,640	2,790	2,930	12,630
Savings from CBO Baseline						
Budget Authority	-830	-2,260	-5,890	-8,510	-10,810	-28,300
Outlays	-630	-1,880	-4,940	-7,710	-10,060	-25,220

About 27 percent of 1987 defense appropriations supports the operation and maintenance (O&M) of existing plant and equipment. Part of this account pays for civilian workers. The rest purchases goods and services for maintenance of existing equipment, training, fuel and spare parts, base operations, and many other things. Spending for these activities is commonly referred to as "readiness" spending since it contributes directly to the day-to-day capability of the military forces.

Since 1982, O&M budget authority has increased about 16 percent in real terms. Although some of this growth was needed to support an increase in forces for both the Navy and Air Force, much of it, according to the Department of Defense, was used to increase the readiness and training of forces that already existed. Current budget plans call for O&M budget authority to increase about 15 percent in real terms during the next five years. Presumably this higher funding stems from the cost of operating new equipment and of placing current forces at an even higher state of combat readiness and effectiveness.

These increases in O&M could be appropriate if history is a guide. The total value of all defense weapons will increase at an average rate of about 3 percent annually in real terms through 1992, assuming that the Administration carries out its current defense plans. Over the last 10 years, O&M has correlated reasonably closely with the total value of weapons. If this relationship continues, demands for O&M could increase.

On the other hand, substantial increases in O&M would not be needed if the services limited their O&M spending per weapon in the future to what they spend today. Based on five-year force structure and modernization plans submitted by DoD, CBO estimates that planned changes would require an average real increase of about 1 percent in O&M spending over the next five years, if spending per weapon remained unchanged. Because DoD claims that current forces are at a high level of readiness, it is not unrealistic to assume that the current level of spending per weapon is adequate.

If improvements to date in force readiness were deemed sufficient, growth in real O&M funds could be slowed. In 1987, the Congress reduced the Administration's request in budget authority for O&M by about 9 percent which resulted in about 2 percent real growth in budget authority over the 1986 level. In addition, the Congress agreed to refunds from the various service stock funds to the operation and maintenance accounts. These refunds are not figured into the real growth figure. Limiting the O&M funding to 1 percent real growth in 1988, and then allowing it to increase at rates proposed by the Administration in subsequent years, would save $2.4 billion in budget authority in 1988 and a total of $13.6 billion over the next five years relative to the Administration's request. Relative to the CBO baseline, this option would exceed the baseline by $0.8 million in fiscal year 1988 and by $28.3 billion over the next five years. This might require reducing some operating tempos relative to the Administration's planned level, unless operating and maintenance efficiencies could be realized. CBO cannot specify in detail the effects of such a limit because of the large number of O&M projects, each of which could be affected differently.

DEF-18 REDUCE ACTIVE-DUTY END STRENGTH TO 1982 LEVEL

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	390	1,380	2,280	2,880	3,010	9,940
Outlays	260	930	1,580	2,020	2,160	6,950
Savings in Defense Budget a/						
Budget Authority	410	1,440	2,370	3,000	3,150	10,370
Outlays	380	1,400	2,340	2,960	3,140	10,220

a. Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel and in the treatment of social security withholdings.

Since 1980, active-duty end strength (the total number of active-duty military personnel at the end of the fiscal year) has increased by 6.6 percent, from 2,040,000 in 1980 to 2,174,000 authorized for 1987. Much of this increase was used for expanded forces in the Navy and the Air Force. For example, in 1980 the Navy had a total of 479 battle force ships, including 13 deployable aircraft carriers. In 1987, the number of battle force ships will reach 567, an increase of 18 percent, with 14 deployable aircraft carriers. Similarly, the Air Force increased the number of its tactical fighter wings from 34 in 1980 to 37 in 1987.

It isn't clear that the Administration's national security policy requires this increase in forces. Rather than follow previous approaches in planning capabilities to fight one major war--or one major war plus a separate minor conflict--this Administration has been less specific about its strategy for conventional forces. Recently, however, Secretary Weinberger has indicated that the Administration's conventional strategy is not so different from the strategy of previous Administrations.

Moreover, budget constraints have not allowed the Administration to achieve all of its original force goals. Although the Navy expects to achieve a numerical goal of 600 ships by the end of fiscal year 1989 when new ships already funded by the Congress will join the fleet, it will be an older fleet and a different mix than originally planned. Nor has the growth in active-duty manpower for the Navy kept up with what would be needed to man the

600 ships fully while maintaining what the Navy would consider a desirable rotation between sea and shore duty. The Air Force goal of 40 tactical fighter wings by 1986 was revised downward to maintain the current 37-wing structure. The Army increased its total number of active force divisions from 16 to 18 by decreasing the size of previously existing divisions and transferring some support responsibilities from the active to the reserve forces. Thus, the Administration would argue that the further increases in personnel and force structure proposed in its budget are necessary to meet defense needs.

On the other hand, if efforts to reduce the budget deficit constrained future defense budgets below today's levels, current active-duty end strength might be reduced. Overall spending reductions might lead to reductions in personnel in order to maintain at acceptable levels the spending for high-priority programs for research and procurement--such as the Advanced Technology Bomber (ATB), Advanced Tactical Fighter (ATF), and the Strategic Defense Initiative (SDI)--and to retain spending for day-to-day operations at about today's level.

One alternative would be to reduce active-duty end strength by 75,000 below the 1987 level over the next two years, leaving it at about the level authorized in 1982. Immediate savings under this alternative in the personnel accounts would be $390 million in budget authority in 1988 and $9.9 billion over the next five years, assuming the reductions are applied proportionally and at all pay grades. These savings reflect reduced costs for personnel and personnel support. Even when the reduction was implemented fully, however, the cuts would amount to about 1 percent of the total defense budget, far less than the 3.5 percent reduction in personnel.

Achievement of further cost savings would depend on how the reductions were accommodated. Reductions of this magnitude could require changes in the force structure. For example, the Navy would be hard pressed to man all of its ships and might have to retire many ships earlier than planned. The number of deployable aircraft carrier battle groups might fall to 13, the number that existed in 1982. The Air Force might have to reduce to 36--the 1982 level--the number of tactical fighter wings and retire some B-52s early (see DEF-16). The Army could deactivate two divisions, returning to the 16 active divisions that existed before 1985. These reductions in force structure should eventually lead to substantial reductions in procurement costs as fewer weapons are needed. Such reductions might take several years, however, since much of the procurement planned in the next few years would be needed to modernize the forces that would remain even after the cuts called for in this option. Moreover, some of the personnel reductions under this option could be accomplished by reducing overhead

rather than fighting units, which would not lead to procurement savings even in the long run.

Nevertheless, force changes of this magnitude would inevitably reduce defense capabilities. The number of ships actively deployed at any given time during peacetime would be reduced from current levels. In the event of a major war with the Soviet Union, there would be fewer tactical air and combat ground forces than there are today. No one can assess precisely the effect this would have on the outcome of a major war in Europe, but it would add risk. Force levels would still match those that existed in 1982, however, and by most measures offered by DoD, the quality of the forces today is higher than it was at that time. Thus, although defense capabilities under this option would be lower for some contingencies, they would exceed the 1982 levels.

In addition, the losses in capability caused by reductions in end strength would be mitigated somewhat by the productivity-enhancing effect of increased seniority in the services' enlisted forces. Average experience is increasing in all the military services. Evidence on experience/productivity trade-offs in the military is limited, but what evidence is available suggests that increases in seniority could offset roughly one-third to one-half of this option's cuts in enlisted end strength in terms of aggregate effectiveness. This result assumes that the cuts would affect all years of service equally, the same assumption underlying the above cost figures. If, instead, the cuts were accomplished entirely through reduced recruitments in fiscal years 1988 and 1989, the offset would be on the order of 60 percent to 80 percent, with some reduction in cost savings. While increased productivity would not necessarily affect the force reductions required because of cuts in end strength, it would make the remaining forces more effective than they currently are.

DEF-19 SLOW THE GROWTH IN ARMY ACTIVE GUARD AND RESERVE PERSONNEL

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	70	220	390	600	840	2,120
Outlays	50	150	270	420	600	1,490
Savings in Defense Budget a/						
Budget Authority	70	230	410	620	870	2,200
Outlays	70	220	400	610	850	2,150

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel and in the treatment of social security withholdings.

Army Active Guard and Reserve (AGR) personnel are full-time military members who are assigned to reserve components. In the event of war, they would join their part-time reserve units as full-time soldiers. The AGR personnel levels generally increase to support specific units and missions as reserve components expand. To accompany its proposed growth in the Army Reserve and Army National Guard, the Administration's plan calls for an increase in Army AGR personnel from 37,467 in 1987, or 4.9 percent of Army total reserve strength, to 55,450 in 1992, or 6.5 percent of total strength.

Active Guard and reserve personnel fill an important need. They perform a variety of administrative tasks, including the management of equipment maintenance and coordination of training programs so that, when part-time reserve personnel serve on weekends, they can concentrate on training. Nor are the numbers of Army AGR personnel out of line with the other services. About 4.9 percent of the total strength of the Army National Guard and Army Reserve are made up of AGRs, compared with 14.9 percent in the Navy Reserve and 4.6 percent in the Air National Guard and Air Force Reserve.

On the other hand, AGR personnel are generally more expensive than typical active-duty soldiers since they have more military experience. Last

year, the Congress reduced the number of full-time reserve personnel below the level proposed by the Administration. The Congress could again alter the funding for AGR personnel by maintaining it at the 1987 authorized level over the next five years. This would save $70 million in budget authority in 1988 and $2.1 billion over the next five years. To the extent that AGRs are necessary to maintain reserve readiness, this approach could increase some units' administrative workloads at the headquarters level and lower some maintenance standards for vehicles and equipment.

DEF-20 LIMIT MILITARY PAY RAISE

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	950	1,300	1,350	1,400	1,460	6,460
Outlays	610	910	970	1,010	1,060	4,550
Savings in Defense Budget a/						
Budget Authority	990	1,350	1,410	1,470	1,520	6,740
Outlays	920	1,330	1,410	1,460	1,520	6,640

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel and in the treatment of social security withholdings.

Under current law, military personnel will receive an annual pay raise in October 1987 that matches the change in private-sector pay. The Administration proposes instead a 4 percent increase effective January 1, 1988. This increase would be similar to the raise assumed in the CBO baseline, which is designed to keep pace with private-sector wage increases since the last military pay raise. Such a raise might not, however, be justified considering the recent strength of recruitment and retention. A 2 percent January increase, coupled with increased spending on first-term reenlistment bonuses as described below, would satisfy many of the purposes of the larger proposed increase at considerable savings. Budget authority would be reduced by $950 million from the Administration's request in 1988, and by $6.5 billion over the next five years (assuming that annual raises after 1988 kept pace with those in the private sector, without any adjustment to recoup the 1987 loss).

The 2 percent raise would represent a compromise between the dictates of pay *comparability* and pay *competitiveness*. In the long term, comparability must be maintained or the services will risk losing their best people to higher private-sector pay. Short-run deviations from comparability may be justified, however, when recruitment and retention conditions are particularly good or bad. The Administration's request would maintain current levels of comparability. Recent retention and recruitment

successes--indicated by first- and second-term reenlistment rates near historical highs and continued high percentages of enlistments by those with high aptitudes and high school diplomas--suggest, however, that a more modest pay increase could give the services a sufficiently strong competitve position to meet their needs. No increase at all, on the other hand, might erode the confidence of service personnel in the long-term commitment by the Congress to pay comparability.

Reduced first-term reenlistment rates resulting from the smaller pay raise could cause a problem. Although the rates would remain high by historical standards, the small number of people entering the service in past years will lead to smaller than usual numbers of second-term service people in the next few years (and eventually, to smaller numbers progressing into the senior career force). If this problem became severe, spending on first-term reenlistment bonuses might have to be increased. A $150 million increase would offset the effect of the less-than-comparable pay raise, and improve the services' abilities to correct imbalances across military occupational specialties. This added spending is not reflected in the above figures.

Selectively adding to the pay of service members beginning their second enlistment tours would contribute to "pay compression"--that is, a reduced pay differential between senior and junior personnel. Although senior service personnel who were unhappy about this compression might not leave in large numbers, they could lose motivation and become less productive. It also is possible that the extra personnel retained by higher first-term bonuses would tend to leave upon completing their additional obligated service. Whether this effect would be undesirable would depend on the services' future requirements for senior career personnel.

DEF-21 RAISE COST-SHARING FOR CERTAIN OUTPATIENTS

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	110	120	120	130	130	610
Outlays	90	110	120	120	130	570

Several categories of patients receive free care at military outpatient clinics, including dependents of active-duty personnel, retired military personnel, and dependents of retirees. This option would save $70 million in budget authority in 1988 and $410 million over the next five years by charging all but dependents of low-ranking enlisted personnel (E-4 and below) for most outpatient visits made in the continental United States. It would save an additional $40 million in 1988 and $200 million over the five years by doubling the annual deductible under the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS). This fee has not changed since 1966. (Administrative expenses not included in these estimates would offset some of these savings, but the offset should be modest if the military adapts existing or planned automated health information systems to track the fees.)

Under this option, dependents of enlisted personnel above pay grade E-4 and retired enlisted personnel and their dependents would pay $5 for each visit to a military-sponsored clinic. Retired officers and their dependents, as well as dependents of active officers, would pay $10. Total charges would be limited to $100 a year for each enlisted family member and $200 for each officer family member. The annual CHAMPUS deductible would rise to $100 for an individual or $200 for a family.

Charging outpatients would help the Department of Defense defray the $58 it spends on average for each outpatient visit. It would also reduce the demand for scarce medical services. People tend to overuse free medical services, thus contributing to overcrowding in military clinics. Reduced clinic services would benefit DoD by freeing resources for use in other areas, such as inpatient care. Moreover, this option would give military beneficiaries an incentive to participate in DoD's new voluntary CHAMPUS Reform Initiative (which will use special networks of civilian medical providers) by raising the cost of continuing to receive outpatient care in mili-

tary facilities or through the current CHAMPUS program. (The Administration is planning to collect nominal fees from some non-active-duty outpatients on a limited test basis; potential savings, however, do not appear in the President's budget.)

Because of medical care's importance as a part of military compensation, military families might view an outpatient charge as an erosion of benefits. Recruitment and especially retention could suffer, although the parallel trend in civilian medicine towards greater cost sharing might limit dissatisfaction by military personnel. Indeed, findings from the department's 1984 health-care survey suggest that many enlisted families would accept a $5 fee: if they had to pay that amount, 60 percent of the outpatients from active enlisted families and 80 percent from retired enlisted families would still have wanted to visit a military physician. Nor should a fee significantly harm health, a concern of some, since evidence shows that people at ages and incomes typical of military beneficiaries seek necessary medical care even when they must share the costs.

ENTITLEMENTS AND OTHER MANDATORY SPENDING

Entitlements and other mandatory spending represent the largest single category of federal spending. Excluding agricultural price supports, which this report considers in a separate section, entitlement outlays equalled 44 percent of federal outlays in 1986. 1/ If no changes are made in current policies, spending for entitlements is expected to increase from $432 billion in 1986 to an estimated $642 billion in 1992, or 49 percent of total outlays. This chapter presents 21 options that would either reduce outlays for entitlements and other mandatory spending or would increase general or earmarked revenues--for entitlement-related functions--compared with the CBO baseline.

Entitlement programs provide benefits to all people or jurisdictions who are eligible to receive aid and who choose to participate. The level of spending in entitlement programs is determined, not by the annual appropriations process, but rather by the program rules that govern eligibility and the extent to which eligible persons or entities participate. As a result of a variety of factors--including demographic shifts, changes in provider practices, and cost-of-living adjustments (COLAs)--outlays for entitlements vary automatically. To curtail the growth in spending for these programs, the Congress must modify the laws governing an entitlement program's eligibility, benefits, or reimbursement of providers for their services.

As Figure 4 indicates, Social Security is the largest entitlement program, accounting for 46 percent of federal spending on nonfarm entitlements in 1986; other federal retirement and disability programs constituted an additional 11 percent. Medicare, the second largest entitlement pro-

1. All figures on spending for entitlement programs exclude agricultural price supports because this report considers farm price supports in a separate section. Including agricultural price supports, entitlements equalled 46 percent of federal spending in 1986 and would grow to an estimated 51 percent of outlays in 1992, if no changes are made in current policies. For a detailed breakdown of entitlement spending by program, including agricultural price supports, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1988-1992* (January 1987), Table II-7, p. 60.

gram, represented 17 percent of spending for entitlements, while other non-means-tested programs--including Unemployment Insurance and veterans' benefits--accounted for 10 percent of these outlays. Medicaid, Food Stamps, Supplemental Security Income, and other means-tested programs made up the remaining 16 percent.

In 1986, approximately one-quarter of entitlement spending went for health programs and three-quarters for non-health programs (see Figure 5). Almost 75 percent of health expenditures were payments for hospital, physician, or other services for Medicare beneficiaries; 25 percent were grants to states for services for Medicaid beneficiaries.

Through the mid-1970s, outlays for nonfarm entitlements grew rapidly as a result of the creation of new entitlement programs and major expansions in eligibility and benefits in both new and already existing programs. Entitlements rose from $33 billion in 1965 to $183 billion in 1976; after accounting for inflation, spending tripled in this period (see Figure 6).

Figure 4.
Composition of Entitlement Outlays by Type of Program, 1986

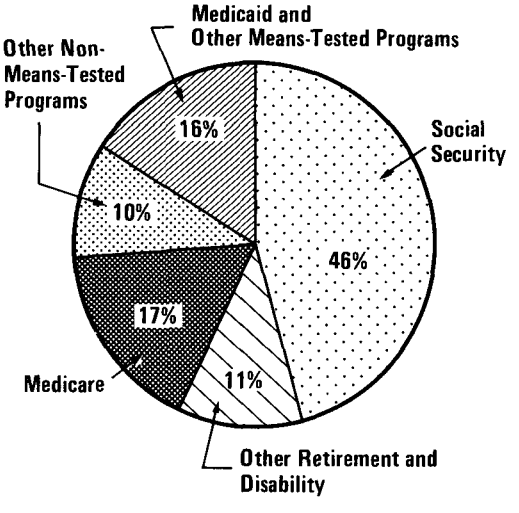
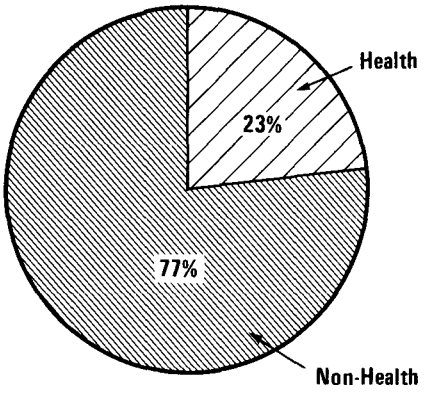


Figure 5.
Composition of Entitlement Outlays by Type of Expenditure, 1986

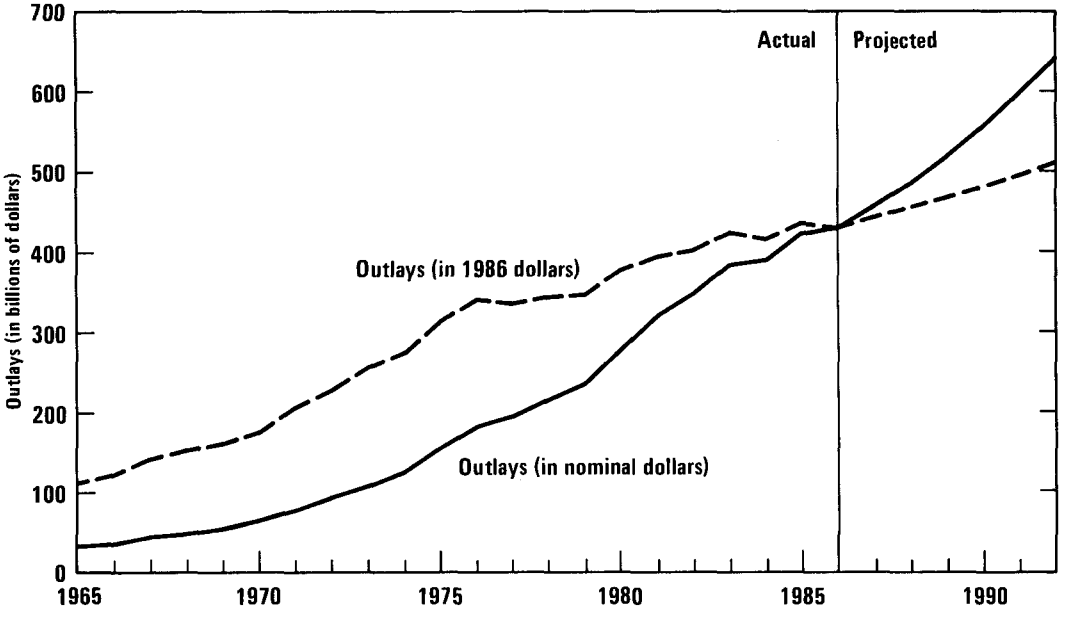


SOURCE: Congressional Budget Office.
NOTE: Figures exclude agricultural price supports.

Although growth in entitlement spending slowed after the mid-1970s, outlays continued to increase. Spending for entitlement programs rose from $183 billion in 1976 to $432 billion in 1986--a 27 percent increase in real terms. Since 1981, legislative actions to slow this growth have been substantial, but, because of phase-in periods, for example, the effects of many changes could be seen only after a lapse of time. Moreover, despite these legislative changes, CBO projects that entitlements will grow more rapidly than overall inflation and will remain about the same proportion of the gross national product over the next five years.

Spending for health programs has grown more rapidly than spending for other entitlements (see Figure 7). While demographic changes--the increased elderly population, for example--have affected both types of entitlements in roughly the same way, health-care benefits per person have risen more rapidly than non-health benefits. A main reason for this differential growth is that health-care prices have risen, and are expected to continue to rise, more rapidly than other prices. For example, the medical care services component of the Consumer Price Index (CPI) rose by 49 percent between 1981 and 1986, while the overall CPI increased by only 23 percent during the same period. In addition, the average beneficiary's use of

Figure 6.
Entitlement Outlays, 1965-1992

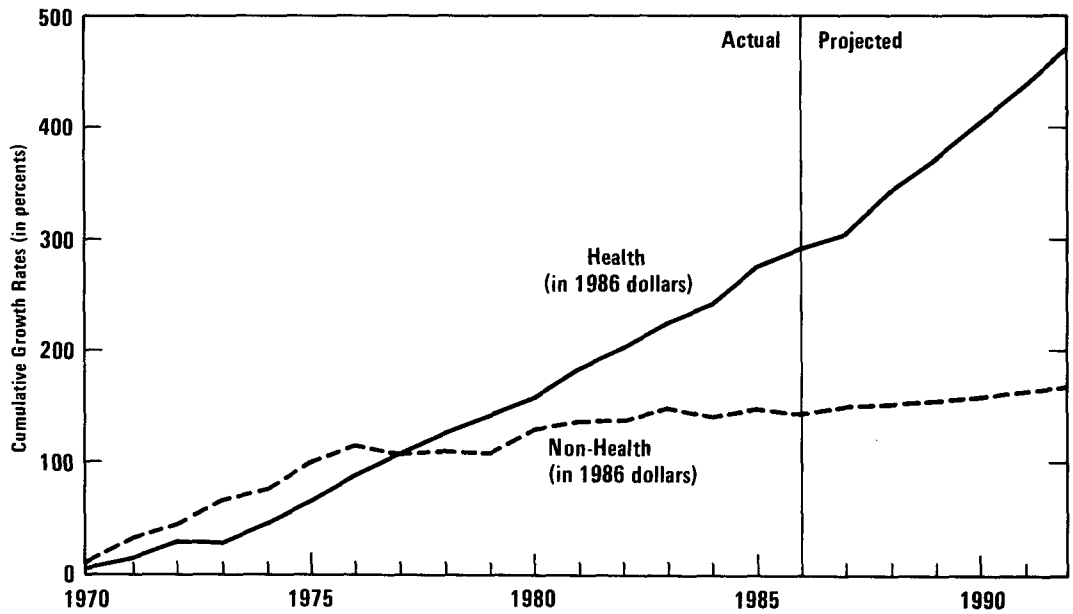


SOURCE: Congressional Budget Office.
NOTE: Figures exclude agricultural price supports.

health-care services--often called intensity--has risen over the same period. Looking to the future, the CBO baseline assumes that these underlying conditions will continue and, therefore, that spending for health entitlements will grow more rapidly than the remainder of this budget category.

During the past year, the Congress curtailed slightly the growth in aggregate spending for entitlement programs; eliminating the over $4 billion General Revenue Sharing (GRS) program was the largest spending change. In other cases--Medicare, Guaranteed Student Loans, and Medicaid, for example--program expansions were enacted at the same time as other options to reduce federal costs, with only a small net effect on federal spending. In several programs--Social Security being the largest--recipients received an unscheduled cost-of-living adjustment (COLA) in January 1987 because the provision that defers COLAs when inflation is low was eliminated. The overall result of all changes in entitlement programs, including the 1986 sequestration, is that total outlays were reduced, compared with the CBO baseline, by about $5 billion in 1987 and approximately $6 billion in 1989, or about a 1 percent reduction in spending for entitlement programs. In addition, federal revenues increased because the maximum wage base for Social Security taxes increased with the unscheduled COLA.

Figure 7.
Cumulative Growth Rates in Entitlement Outlays by Type of Expenditure, 1970-1992



SOURCE: Congressional Budget Office.
NOTE: Figures exclude agricultural price supports.

The Congress could curtail the growth of spending in entitlement programs in three main ways--limiting payments to providers, reducing or eliminating aid to beneficiaries, or increasing receipts. The options presented in this chapter include examples of each approach.

The first way--altering payments to providers of services for beneficiaries--has been used extensively in the past, especially in the Medicare program. Some changes in payments to health-care providers might not affect recipients; other changes, especially substantial ones, could affect beneficiaries adversely--reducing their quality of care or increasing their expenditures, for example. ENT-01 through ENT-04 would limit Medicare's payments to hospitals; ENT-05 and ENT-06 would reduce payments for physicians' services.

Alternatively, the Congress could cut spending by eliminating eligibility for certain groups felt to be less in need or by reducing benefits for some or all program recipients. ENT-14 through ENT-18 are examples of this approach.

Under the third approach, the Congress could increase receipts either from current beneficiaries (ENT-07 through ENT-11) or from broad groups of taxpayers (ENT-13, ENT-19 through ENT-21). The former set of options would reduce federal costs by requiring recipients to pay more; the latter set would increase general or earmarked revenues. In addition, some of the options would reduce the use of services, especially health-care services. ENT-12 is a hybrid approach because it would reduce federal payments to states that could in turn cut payments to providers, limit benefits, raise revenues, or use some combination of these three approaches. Several other options to increase revenues for entitlement-related functions (REV-18 through REV-20) are discussed in the revenue section of this report.

In this section, options to reduce spending for entitlement programs or to increase revenues are organized by program area. ENT-01 through ENT-13 concern health-care programs. ENT-14 through ENT-16 discuss alternatives for reducing net federal outlays for Social Security and other retirement and disability programs. ENT-17 through ENT-21 address other entitlement programs.

ENT-01 RECALCULATE MEDICARE'S PROSPECTIVE PAYMENT RATES USING MORE RECENT COST DATA

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Reduce the Payment Rates by 10.1 Percent						
Outlays	4,400	4,850	5,400	5,950	6,600	27,200
Reduce the Payment Rates by 7.1 Percent						
Outlays	3,050	3,350	3,750	4,150	4,550	18,900

The Social Security Amendments of 1983 established the current prospective payment system (PPS) under which Medicare reimburses hospitals for inpatient services provided to beneficiaries. Payment rates are set in advance for each of 471 diagnostic categories known as diagnosis-related groups (DRGs). By the end of fiscal year 1988, all payments to hospitals will be based on national rates, calculated separately for urban and rural areas, using 1981 cost data that had been inflated to represent 1984. For fiscal years 1985 to 1987, the rates were updated annually by the Secretary of the Department of Health and Human Services (HHS) and by the Congress. Actual cost data for 1984 have just recently become available.

The new data provide information that could be used both to make technical adjustments to the PPS rates and to evaluate the overall generosity of the system. Because a system that incorporated the technical adjustments would more accurately reflect the situations of hospitals when the PPS began, many analysts urge the adoption of these adjustments--a change often referred to as "rebasing" the system. A simple approach that would address technical difficulties with the relative rates now paid to urban and rural hospitals would be to replace the 1981 data with those from 1984, but leave all other components of the pricing system--for example, the "update factors" for 1985 through 1987--at their historical values. In this case, the rebased rates would be 10.7 percent lower for urban hospitals and 7.3 percent lower for rural hospitals (for a weighted average of 10.1 percent), reflecting the cost reductions hospitals had achieved by 1984 rela-

tive to what had been expected based on pre-PPS costs. The new rates would not, however, incorporate any further improvements in efficiency or make any other technical adjustments to the PPS system. (See, for example, ENT-02 which describes a possible modification to the indirect teaching adjustment.)

If these rebased rates were implemented, Medicare's outlays would be reduced by $27.2 billion during the 1988-1992 period. While there is general agreement that relative rates should be recalculated using the 1984 data, more controversy surrounds the question of whether the level of aggregate Medicare payments to hospitals should be reduced at the same time.

Proponents of lowering total payments when rebasing the system argue that it is currently too generous, in part because hospitals have reduced their costs substantially both before and after the implementation of the PPS. During the past few years, the Secretary of HHS and the Congress tried to account for these cost reductions by holding the annual update factors below the estimated increases in the prices of goods and services hospitals purchase. Despite these attempts, aggregate payments are expected to exceed aggregate costs by 11.5 percent in fiscal year 1987. Proponents contend, therefore, that lower and rebased payments would reflect more recent costs and technologies for providing care in a rapidly changing industry. For example, some services formerly provided during an inpatient stay, and hence included in 1981 costs, are now provided in outpatient settings or skilled nursing facilities where they are separately reimbursed on a reasonable-cost basis. Therefore, the lower rebased rates would avoid what is, in effect, double payment for these services.

Opponents argue that some or all of the current surplus should be left in a rebased system. The hospital industry believes it should be able to retain at least some of this surplus since the ability to profit, along with the risk of costs exceeding payments, was an integral part of the financial incentives provided by the system. In addition, some analysts point out that inadequacies in the PPS rates--for example, the way they account for severity of illness and wage differences among areas--adversely affect particular hospitals in an unfair and unintended manner. Therefore, they maintain that some of the aggregate surplus should be retained as a cushion until the PPS system can be improved, because only by paying more to all hospitals could the unfairly affected ones be helped. If, for example, three percentage points were left in the system--that is, if the urban rates were reduced by 7.7 percent and the rural rates by 4.3 percent (for a weighted average of 7.1 percent)--Medicare outlays would fall by $18.9 billion over the 1988-1992 period.

ENT-02 REDUCE MEDICARE'S PAYMENTS FOR THE INDIRECT COSTS OF MEDICAL EDUCATION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	370	450	500	550	600	2,470

Medicare's prospective payment system (PPS), which is described in ENT-01, pays higher rates to hospitals with teaching programs to cover their additional costs of Medicare patient care. The federal portion of payments to these hospitals is raised by approximately 8.1 percent for each 0.1 percentage point of the hospital's ratio of full-time equivalent interns and residents to its number of beds. This adjustment was calculated to compensate hospitals both for their indirect teaching costs--such as the greater number of tests and procedures thought to be prescribed by interns and residents--and to cover higher costs caused by a variety of factors that are not otherwise accounted for in setting the PPS rates. These factors include severity of illness within diagnosis-related groups (DRGs), location in inner cities, and a more costly mix of staffing and facilities--all of which are associated with large teaching programs. If payments for the costs of treating a "disproportionate share" of low-income patients (a characteristic also associated with teaching programs) had also been included in the indirect teaching adjustment, it would have been 8.7 percent. The difference (0.6 percentage points), which is not paid as part of the indirect adjustment, is used to finance part of the payments that are now made under a separate adjustment to hospitals for the costs of treating a disproportionate share of low-income patients.

If the indirect teaching adjustment were reestimated using the new cost data for 1984 (which imply an adjustment of 6.9 percent rather than 8.7 percent), and the financing of the disproportionate-share adjustment were also recalculated, then outlays would fall by $2.5 billion over the 1988-1992 period.

Proponents point out that this option would better align payments with the actual costs incurred by teaching institutions, which fell substantially in real terms between 1981 and 1984. On the other hand, this alternative would considerably reduce payments to teaching hospitals, thereby potentially lowering the access and quality of care for some beneficiaries.